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New South Wales
TREASURY

Accounting Policy: Accounting for Financial Instruments

OFFICE OF FINANCIAL MANAGEMENT

Policy & Guidelines Paper

Preface

This Policy and Guidelines Paper *Accounting for Financial Instruments* provides guidance to NSW public sector agencies in applying AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 132 *Financial Instruments: Presentation* and AASB 7 *Financial Instruments: Disclosures,* including:

- likely classification of financial instruments
- restrictions on the use of certain categories of financial instruments
- derivatives and hedge accounting
- interest free and low interest loans
- financial guarantees and
- NSW Treasury's mandates.

This Policy is applicable to all NSW public sector agencies (including Statutory State Owned Corporations) for financial years beginning on or after 1 January 2007. It supersedes the previous Treasury Policy and Guidelines Paper of the same name (TPP 07-2).

For further information on this policy, please contact Treasury's Accounting Policy Section on telephone (02) 9228 4095.

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NSW Treasury
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Executive Summary

This Policy:

- Requires that financial instruments be classified, recognised and measured in accordance with the relevant AASB 139 *Financial Instruments: Recognition and Measurement* categories.
- Summarises the likely classification of typical financial instruments held by agencies. However, agencies will need to confirm this categorisation for their own circumstances.
- Discusses some of the key disclosure requirements for financial instruments in AASB 7 *Financial Instruments: Disclosures*.
- Requires agencies to identify and confirm all significant inter-agency financial instrument transactions and balances to ensure consistent treatment.
- Mandates that the Treasury Corporation Hour-Glass Investment Facilities be designated at 'fair value through profit or loss', if not otherwise classified as 'held for trading'. This will require the agency to demonstrate that these assets are managed and their performance is evaluated on a fair value basis, in accordance with the Standard.
- Requires agencies to disclose the movements in the TCorp Hour-Glass Investment Facilities (including any distributions) as part of revenue in the operating statement.
- Restricts the use of the following three categories of financial instruments:
  - held-to-maturity investments
  - fair value designation option
  - available-for-sale designation option.
- Requires agencies to obtain written approval from NSW Treasury to use the above three categories of financial instruments and requires agencies to demonstrate the basis and reasons for the classification or designation.
- Provides guidance regarding derivatives, hedge accounting, interest free and low interest loans, financial guarantee contracts and impairment.
- Specifies NSW Treasury mandates, where AASB 139 includes options.
- Provides practical examples of an:
  - Amortised cost calculation, using the effective interest method.
  - Interest free loan accounting treatment.
- Summarises the main differences compared to previous Australian requirements as outlined in TPP 07-2 arising from the adoption of AASB 7, including additional quantitative and qualitative disclosure requirements.

1. Introduction

1.1 Purpose of Policy

The purpose of this policy is to provide guidance and outline NSW Treasury's requirements for applying AASB 139 *Financial Instruments: Recognition and Measurement*, AASB 7 *Financial Instruments: Disclosures* and AASB 132 *Financial Instruments: Presentation* by NSW public sector agencies including:

- general requirements for the classification, recognition, measurement and disclosure of financial instruments in accordance with AASB 139, AASB 7 and AASB 132 (section 2)
- the likely classification of financial instruments into the AASB 139 categories (sections 2.1 and 2.2)
- restrictions on the use of the following three categories of financial instruments
  - held-to-maturity investments (section 4)
  - fair value designation option (section 5.3)
  - available-for-sale designation option (section 6)
- guidance and requirements regarding accounting for
  - derivatives and hedge accounting (section 8)
  - interest free and low interest loans (section 9)
  - financial guarantee contracts (section 10) and
  - impairment losses (section 11)
- NSW Treasury's mandates (section 12).

1.2 Application

This Policy is issued as a Treasurer's Direction under sections 9 and 45E of the *Public Financial and Audit Act 1983* and therefore applies to all entities required to prepare general purpose financial statements under the Act. The Policy is also mandatory for statutory State Owned Corporations. A specific reference to the Policy will be included in the Statements of Corporate Intent of those entities.

This Policy applies to financial years beginning on or after 1 July 2007 and supersedes TPP 07-2. This Policy has been updated for amendments to Australian Accounting Standards applicable from 2007/08.

The main difference compared to the previous TPP 07-2 is guidance on additional quantitative and qualitative disclosure requirements as a result of the introduction of AASB 7.

The Policy (and AASB 7/AASB 132/AASB 139) must be applied retrospectively by adjusting the opening balance of each affected component of equity at the beginning of the comparative period. This is consistent with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors.*

2. General requirements

AASB 139 requires the initial measurement of financial instruments at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, directly attributable transaction costs (AASB 139.43).

Subsequent to initial recognition, AASB 139 requires entities to classify, recognise and measure financial instruments in accordance with the relevant AASB 139 categories, as follows:

- financial assets and financial liabilities at 'fair value through profit or loss', which includes those 'held for trading' and those designated as held at 'fair value through profit or loss'
- held-to-maturity investments
- loans and receivables
- available-for-sale financial assets
- non-trading financial liabilities[1]
- derivatives that are designated and effective hedging instruments
- financial guarantee contracts and
- other financial liabilities[2].

AASB 139 adopts a mixed measurement model. It requires or permits certain categories of financial instruments to be measured on a fair value basis (i.e. financial assets and financial liabilities at 'fair value through profit or loss', 'available-for-sale' financial assets and derivatives subject to hedge accounting); and requires other categories of financial instruments to be recognised at amortised cost (i.e. 'held-to-maturity' investments, 'loans and receivables' and 'non-trading liabilities'). These categories are detailed in Appendix A to the Policy.

AASB 139 requires that all financial assets, except those measured at fair value through profit and loss, must be subject to review for impairment (AASB 139.58-70 and paras AG84-AG93) (refer section 11).

In addition, AASB 139 includes some options and NSW Treasury has mandated the following:

- The NSW Treasury Corporation Hour-Glass Investment Facilities must be designated at 'fair value through profit or loss', if not otherwise classified as 'held for trading'.
- The use of the following three categories of financial instruments is restricted:
  - 'held-to-maturity' investments
  - fair value designation option
  - 'available-for-sale' designation option.

  To use the above categories, agencies must obtain written approval from NSW Treasury (except that written approval is not required for TCorp Hour-Glass Investment Facilities). To obtain approval, agencies will need to demonstrate the basis and reasons for the classification or designation (refer sections 4-6).

[1] This Policy refers to financial liabilities that are measured at amortised cost using the effective interest method as 'non-trading' financial liabilities (refer section 7).

[2] This Policy refers to financial liabilities that do not fit into any of the preceding categories as 'other financial liabilities'. These are briefly discussed in Appendix A.

The likely classification of typical financial instruments held by agencies is summarised below. Agencies will need to confirm this categorisation for their own circumstances.

2.1 Likely classification of financial assets

Type of financial asset	Likely classification
Receivables and loans	Normal trade receivables and loan assets that are not quoted in an active market will typically be classified as 'loans and receivables' in accordance with AASB 139 and must be measured at amortised cost (refer section 3). Low or zero interest loans must be recorded at fair value on inception and amortised cost thereafter. This may result in recognition of grant expense/ revenue on day one and interest revenue / expense throughout their life (refer section 9 and Appendix C to the Policy).
Treasury Corporation Hour-Glass cash facility	These typically meet the definition of 'cash and cash equivalents' under AASB 107 *Cash Flow Statements*. These are measured at fair value with interest revenue accrued as earned such that the fair value is reflected at no less than the amount payable on demand (consistent with AASB 139.49).
Treasury Corporation Hour-Glass Investment Facilities	This includes investments in the bond market, medium term growth and long term growth facilities. If not otherwise classified as 'held for trading', this Policy requires that these facilities should be designated at 'fair value through profit or loss' (refer section 5).
Deposits at TCorp and with other financial institutions	Normal at-call and short term deposits (generally three months or less) held at TCorp or with other financial institutions that are not quoted in an active market will typically meet the definition of, and be classified as, cash. Otherwise, deposits are likely to be 'loans and receivables' in accordance with AASB 139 and measured at amortised cost.
Other investments	This may include other investments, such as securities that are quoted in an active market. Classification of these investments will vary depending on their characteristics and the agency's intent. Possible classification alternatives (subject to NSW Treasury approval, where required) are (refer sections 4-6): – available-for-sale – held-to-maturity – held for trading – designated at fair value through profit or loss.

Type of financial asset	Likely classification
Derivatives	Derivatives that are designated and effective hedging instruments must follow the hedge accounting requirements in AASB 139 (refer section 8). All other derivatives are classified as 'held for trading' and are therefore recognised as a financial asset or liability at 'fair value through profit and loss.'
Interests in subsidiaries, associates, joint ventures; rights under leases, employee benefit plans and prepayments.	Excluded from the scope of AASB 132 (AASB 132.4 and AASB 132.11) and AASB 139 (AASB 139.2). These assets are accounted for under other relevant Standards.
Statutory assets; i.e. that are not contractual but are created as a result of statutory requirements imposed by governments	Excluded from the scope of AASB 132 (AASB 132.AG12) as they are not financial assets. These assets are accounted for under other relevant standards.

2.2 Likely classification of financial liabilities

Type of financial liability	Likely classification
Payables	Normal trade payables will typically be classified as 'non-trading liabilities' (refer section 7) in accordance with AASB 139 and must be measured at amortised cost.
Borrowings from TCorp or other financial institutions	Where these are direct loans, these are usually classified as 'non-trading liabilities' (refer section 7) and measured at amortised cost, unless they are classified or designated at 'fair value through profit or loss' (refer section 5). Low or zero interest loans must be recorded at fair value on inception and amortised cost thereafter. This may result in recognition of grant revenue/expense on day one and interest expense/revenue throughout their life (refer section 9 and Appendix C to the Policy).
Derivatives	The accounting treatment is the same as for 'derivative' financial assets, as discussed above (also refer section 8).
Financial guarantees	Financial guarantees that satisfy the definition of a 'financial guarantee contract' (AASB 139.9) are subject to separate measurement requirements; i.e. after initial recognition, measured at the higher of the amount determined in accordance with AASB 137 *Provisions* and the amount initially recognised (i.e. fair value) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 *Revenue* (refer section 10).

Obligations under leases, provisions and accruals, revenue in advance, employee benefit plans, and insurance contracts etc	Excluded from the scope of AASB 132 (AASB 132.4 and AASB 132.11) and AASB 139 (AASB 139.2). These liabilities are accounted for under other relevant Standards.
Statutory liabilities; i.e. that are not contractual but are created as a result of statutory requirements imposed by governments	Excluded from the scope of AASB 132 (AASB 132.AG12) as they are not financial liabilities. These liabilities are accounted for under other relevant standards.

2.3 Disclosure

Agencies are required to make extensive disclosures regarding financial instruments in accordance with AASB 7 *Financial Instruments: Disclosures* (and parts of AASB 101 *Presentation of Financial Statements*). AASB 7 substantially increases the quantitative and qualitative disclosures regarding an agency's exposure to risks, including credit risk, liquidity risk and market risk (refer Appendix D)

2.3.1 Summary of AASB 7 / AASB 101 requirements

Some of the key AASB 7 / AASB 101 disclosure requirements regarding financial instruments are:

- The measurement basis (or bases) used in preparing the financial report and the other accounting policies used that are relevant to an understanding of the financial report (AASB 7.21).
- The judgements that management makes in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial report (AASB 7.B5 and AASB 101.113).
- The separate carrying amounts of each of the following categories (AASB 7.8):
  - financial assets and financial liabilities at fair value through profit or loss, showing separately those designated as such upon initial recognition and those classified as held for trading
  - held-to-maturity investments
  - loans and receivables
  - available-for-sale financial assets and
  - financial liabilities measured at amortised cost.
- Net gains or net losses on each category of financial instruments, including gains or losses / ineffectiveness on fair value hedges / cash flow hedges recognised in profit or loss (AASB 7.20(a) and AASB 7.24).
- Total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss (AASB 7.20(b)).
- The amount of any impairment loss for each class of financial asset, as well as a reconciliation of changes during the reporting period in the allowance account for impairment for each class of financial assets (AASB 7.20(e) and AASB 7.16).

- Where an agency designates financial instruments at 'fair value through profit or loss', using the fair value option, the agency must disclose (AASB 7 B5(a) and section 5 below):
  - the criteria for so designating such financial assets or financial liabilities on initial recognition
  - how the entity has satisfied the conditions for such designation in AASB 139.9, 11A or 12 and
  - the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss.
- Information that enables users to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed and how these risks have been managed. This includes quantitative and qualitative information for each type of risk; i.e. credit risk, liquidity risk and market risk (AASB 7.31 and 32).
- Qualitative information on each type of risk (AASB 7.33):
  - exposures to risk and how they arise
  - objectives, policies and processes for managing risk and methods used to measure risk and
  - any changes in the above from the previous period.
- Quantitative data about the exposure to each type of risk arising from financial instruments and concentrations of risk, based on information provided to key management personnel of the agency (AASB 7.34). If the data is not representative of the agency's exposure to risk during the period, the agency must provide further information that is representative (AASB 7.35).
- Credit risk disclosures, by class of financial instrument (AASB 7.36-38), including:
  - maximum exposure to credit risk and details regarding collateral held as security
  - credit quality of financial assets that are neither past due nor impaired
  - an analysis of the age of financial assets that are past due but not impaired as at the reporting date and
  - an analysis of financial assets that are determined individually to be impaired as at the reporting date, including the factors the agency considered in determining that they are impaired.
- Liquidity risk disclosures, including a maturity analysis for financial liabilities that shows the remaining contractual maturities using undiscounted cash flows (which will not reconcile to the carrying amounts in the balance sheet) and a description of how the agency manages the inherent liquidity risk (AASB 7.39). An agency uses judgement to determine an appropriate number of time bands.
- Market risk disclosures, including a sensitivity analysis for each type of market risk (interest rate risk, currency risk and other price risk) to which the agency is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date (AASB 7.40).

  In determining what a reasonably possible change in the relevant risk variable is, the agency should consider the economic environment in which it operates and the time frame over which it is making the assessment. A reasonably possible change should not include remote or 'worst case' scenarios (AASB 7 B19).

When the sensitivity analyses disclosed are unrepresentative of a risk inherent in a financial instrument (because the year-end exposure does not reflect the exposure during the year), the agency should disclose that fact and the reason it believes the analyses are unrepresentative (AASB 7.42).

- For for-profit entities only, capital management disclosures based on information provided internally to the agency's key management personnel (AASB 101.124A-124C).

The above is not an exhaustive list of the AASB 7 / AASB 101 disclosure requirements and agencies must refer to the Standards to ensure full compliance.

2.3.2 Information for AASB 7 disclosures

To assist in the AASB 7 disclosures, NSW Treasury Corporation (TCorp) will provide the following information to agencies, where relevant:

- Unrealised gains / losses on derivatives, including commodity swaps, FX forwards and currency options (AASB 7.20).
- Contractual maturity analysis for agency liabilities payable to TCorp, based on undiscounted cash flows (including fixed / variable loans) (AASB 7.39)[3].
- Sensitivity analysis information for each of the TCorp Hour Glass Facilities and for derivatives (AASB 7.40).
- For managed asset and debt clients, additional qualitative disclosures and certain quantitative disclosures.

A sample AASB 7 note disclosure is included in the *Financial Reporting Code for Budget Dependent General Government Sector agencies* (refer Note 39). The note is an example only and agencies should modify or add to the suggested disclosure to suit their own circumstances, including quantitative disclosures based on information provided internally to the agencies' key management personnel. The format of presentation is a decision to be made by each agency.

The *Financial Reporting Code* sample note may also be relevant, as a starting point, for other NSW public sector agencies. For example, the commentary to Note 39 in the *Financial Reporting Code* also includes suggested AASB 7 qualitative disclosures that may be relevant to TCorp managed debt/asset clients.

2.3.3 Reporting to NSW Treasury

NSW Treasury will collate agencies' AASB 7 disclosure information to assist consolidation at the whole of government level.

For whole of government purposes (and general government sector purposes from 2008/09), some of the AASB 7 information will need to be collected outside of the Treasury Online Entry System (TOES) system, as part of a separate data return.

This information may be directly obtainable by the agency from its financial report; for example, the reconciliation of changes in the allowance account during the period for each class of financial assets (AASB 7.16).

[3] TCorp is still developing this report, as at the date of this Policy.

Agencies, however, will need to provide additional information to NSW Treasury to ensure consistency where agencies make different disclosures than those used in the *Report on State Finances* (which includes the whole of government and general government sector), for example:

- time bands for financial assets past due but not impaired and impaired (AASB 7.37):

  NSW Treasury will use the following time bands in the *Report on State Finances*:

  - less than 3 months overdue
  - 3 months to 6 months overdue
  - later than 6 months overdue

- financial liability maturity time bands (AASB 7.39):

  NSW Treasury will use the following time bands in the *Report on State Finances* :

  - less than 1 year
  - 1 year to 5 years
  - later than 5 years

- sensitivity parameters (AASB 7.40):

  The *Report on State Finances* will use a 1% interest rate sensitivity (until otherwise advised). For the TCorp Hour-Glass Facilities, the *Report on State Finances* sensitivity analysis disclosure will be based on information provided by TCorp, using historically based volatility information (which will also be provided to relevant agencies at each year end).

The format of presentation is a decision to be made by each agency. The time bands / sensitivity parameters used in the *Report on State Finances* may be relevant to individual agencies.

2.4 Inter-agency transactions and balances

Key Policy requirement

As part of the year-end processes, agencies need to identify and confirm all significant inter-agency financial instrument transactions and balances, in accordance with instructions issued by NSW Treasury annually. This will assist with eliminations on consolidation at the whole-of-government level.

Confirmation is *not* required for derivatives. Nevertheless, agencies will still be required to submit information regarding derivatives to NSW Treasury to facilitate the whole-of-government consolidation, separately identifying derivatives whose counterparty is another NSW public sector agency.

3. Loans and Receivables

'Loans and receivables' are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market (AASB 139.9 and AG26). Loans and receivables are measured at amortised cost using the effective interest method. The effective interest method is used to determine the carrying amount of a financial asset or liability by allocating the effective interest evenly over the life of an instrument. This is illustrated in Appendix B to the Policy.

Application Guidance to AASB 139 clarifies that short-term receivables (and payables) with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial (AASB 139.AG79).

The 'loans and receivables' category excludes financial assets (AASB 139.9):

- quoted in an active market (such as a quoted debt instrument)
- classified or designated at 'fair value through profit or loss' (refer section 5)
- designated as 'available-for-sale' (refer section 6)
- where the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

Common examples of financial instruments that, subject to above, may be classified as 'loans and receivables' include loan assets, trade receivables, investments in non-quoted debt instruments and deposits held in banks.

Financial assets that do not meet the definition of loans and receivables may be classified as 'held-to-maturity' if they meet the conditions for that classification (see section 4).

4. Held-to-maturity investments

'Held-to-maturity' investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the *positive intention and ability* to hold to maturity (AASB 139.9). Held-to-maturity investments are measured at amortised cost using the effective interest method (AASB 139.46).

The 'held-to-maturity' category excludes those financial assets (AASB 139.9):

- the entity upon initial recognition designates at 'fair value through profit or loss'
- the entity designates as 'available-for-sale' and
- that meet the definition of 'loans and receivables'. That is, the 'held to maturity' category excludes other non-derivative financial assets with fixed or determinable payments that are *not* quoted in an active market, such as loan assets, trade receivables, investments in non-quoted debt instruments and deposits held in banks, where they are classified as 'loans and receivables'.

Examples of financial assets that could potentially be classified as 'held-to-maturity' include quoted debt securities (such as bonds). However, investments in equity instruments, such as shares, cannot be regarded as 'held-to-maturity' as they do not have a fixed maturity (AASB 139.AG17).

Further, an entity does not have a positive intention to hold an investment to maturity if the entity intends to hold the financial asset for an undefined period or the entity stands ready to sell the investment in response to liquidity needs, changes in market interest rates etc. (other than if the situation is non-recurring and could not have been reasonably anticipated by the entity) (AASB 139.AG16).

Additional guidance regarding the 'held-to-maturity' category is included in AASB 139.AG16-AG25.

The 'held-to-maturity' category is viewed as an exception to be used in limited circumstances. As a result, AASB 139 includes strict requirements that restrict entities using this category where more than an insignificant amount of these assets is sold or reclassified out of that category (AASB 139.9). If this restriction is breached, the category cannot be used for a prescribed period and any remaining financial assets in the category must be reclassified as 'available-for-sale' and recognised at fair value (AASB 139.51-52). This restriction applies at both the entity and whole of government level (i.e. the sale of a held-to-maturity investment by <u>one</u> agency prior to maturity could exclude whole of government from using this category for two years).

Key Policy requirement

Given the consequences of incorrect classification, this Policy requires that agencies can only use the 'held-to-maturity' category of financial assets after obtaining written approval from NSW Treasury each year. NSW Treasury will require the agency to demonstrate the basis and reasons for the classification.

5. Financial assets and financial liabilities at fair value through profit or loss

5.1 Definition

The 'fair value through profit or loss' category must be used where a financial asset or financial liability is either (AASB 139.9):

- classified as 'held for trading' or
- upon initial recognition, it is designated by the agency as at 'fair value through profit or loss', where the fair value option criteria are satisfied (referred to in this Policy as the 'fair value designation option' - refer section 5.3).

Financial instruments can only be *classified* as 'held for trading' where they satisfy the definition (refer section 5.2). However, financial instruments that do not meet the definition of 'held for trading' may be *designated* at 'fair value through profit or loss', where they satisfy certain criteria (refer section 5.3).

5.2 'Held for trading' financial instruments

A financial asset or financial liability is classified as 'held for trading' if it is (AASB 139.9):

- acquired or incurred principally for the purpose of selling or repurchasing in the near term
- part of a portfolio of identified financial instruments managed together and for which there is evidence of a recent actual pattern of short term profit taking or
- a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument) (Refer section 8 and section 10).

'Held for trading' financial instruments must be recognised at fair value through profit or loss. NSW Treasury approval is not required to use this category of financial instrument.

5.3 Fair value designation option

Where a financial instrument does not meet the definition of 'held for trading', it may be designated at 'fair value through profit or loss' in certain circumstances. AASB 139 operates to restrict the circumstances where entities can on initial recognition designate financial instruments at 'fair value through profit and loss'.

Under NSW Treasury's Policy, an agency will not be required to exercise the fair value designation option, except in very limited circumstances where:

- it satisfies the AASB 139 fair value option criteria
- it determines it is appropriate for its operations (e.g. NSW Treasury Corporation) and
- it is approved by NSW Treasury.

The fair value designation option may only be used where designation results in more relevant information, because either (or both) of the following is applicable:

- Accounting mismatch - It eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases (AASB 139.9 *financial asset or liability at fair value through profit or loss* (b)(i) and AASB 139.AG4D-AG4G)) or

- Managed and evaluated on a fair value basis - A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management / investment strategy and information about the group is provided internally on that basis to the entity's key management personnel (AASB 139.9(b)(ii) and AASB 139.AG4H-AG4K)).

The fair value option may also be applied where the contract contains one or more embedded derivatives, in certain circumstances (refer Appendix A to the Policy).

Importantly, AASB 7 App B5 requires that, where an entity exercises the fair value option, it must disclose the criteria for so designating, including how the entity has satisfied the particular conditions in AASB 139 for such designation. In particular, it must disclose whether it is doing so to eliminate an accounting mismatch (AASB 139.9(b)(i)) or because these financial instruments are managed and evaluated on a fair value basis (AASB 139.9(b)(ii)).

This information is also important for NSW Treasury to help determine whether or not the fair value option can or should be applied at the whole of government level.

Key Policy requirement

Prior to using the fair value designation option, an agency must obtain written approval from NSW Treasury, except for the designation of the TCorp Hour-Glass Investment facilities – refer section 5.4, below.

In order to obtain NSW Treasury approval, the agency must provide to NSW Treasury each year the same information required to be disclosed by AASB 7 App B5 above, demonstrating and identifying the basis on which it satisfies the fair value option criterion.

Where the fair value option is exercised at the agency level, subject to NSW Treasury review, the agency may be required to provide information to NSW Treasury on an amortised cost basis for whole of government consolidation purposes.

5.4 Designation of TCorp Hour-Glass Investment facilities

The TCorp Hour-Glass Investment Facilities[4] are unit trust investment funds, catering for NSW public sector agencies' investment needs from short term working funds to long term growth investments. They are:

- Bond Market Facility
- Medium Term Growth Facility
- Long term Growth Facility.

[4] The TCorp Hour-Glass cash facility is discussed separately in Section 2.1 of the Policy.

Agencies are issued with a number of units, based on the amount of the deposit and the unit value for the day. The unit value is the net asset value of the Facility divided by the number of units on issue. Unit values rise and fall in line with the value of the underlying investments and all information provided to agencies reflects the fair value of its investment in the facilities.

In terms of AASB 139, it is NSW Treasury's view that measuring such investments at 'fair value through profit or loss' results in more relevant information because these assets, by their nature, can *only* be managed and their performance can *only* be evaluated on a fair value basis. While the 'available-for-sale' category could be applied under AASB 139, this Policy requires designation of these investments at 'fair value through profit or loss', based on the second leg of the fair value option.

The second leg of the fair value option (AASB 139.9(b)(ii)) requires investments to be managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, with information about these investments provided internally on that basis to the entity's key management personnel (KMP). Agencies will need to demonstrate compliance with this requirement.

AASB 139.AG4K clarifies that documentation of the entity's risk management or investment strategy need not be extensive and it is sufficient if the performance management system clearly demonstrates that its performance is evaluated on a total return basis. An agency will need to ensure and demonstrate that the monthly reports generated by TCorp form part of its own performance management system (and information is provided internally to the KMP on that basis), in accordance with the agency's documented risk management or investment strategy.

As further discussed in section 2.3, agencies will need to disclose the basis for designating the Hour-Glass Investment Facilities, as outlined above.

Further, this Policy requires agencies to disclose the movements in the Hour-Glass Investment Facilities (including any distributions) as part of revenue in the operating statement. This is because, where financial instruments are classified or designated at 'fair value through profit or loss', any movements in the fair value of these financial instruments can be taken to arise in the 'course of ordinary activities'. Such fair value movements satisfy the definition of 'revenue' in AASB 118 (AASB 118.7).

Key Policy requirement

This Policy requires that all agencies designate TCorp Hour-Glass Investment Facilities at 'fair value through profit or loss', based on the second leg of the AASB 139 fair value option (AASB 139.9(b)(ii) and section 5.3 above), if not otherwise classified as 'held for trading'.

To satisfy the second leg of the AASB 139 fair value designation option, agencies will need to ensure and demonstrate that these assets are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information is provided internally on that basis to the agency's KMP.

Further, this Policy requires agencies to disclose the movements in the Hour-Glass Investment Facilities (including any distributions) as part of revenue in the operating statement.

6. Available-for-sale financial assets

'Available-for-sale' financial assets are those financial assets that are designated as 'available-for-sale' or that are not classified as (AASB 139.9):

- loans and receivables
- held-to-maturity investments or
- financial assets at fair value through profit or loss.

In limited circumstances, an agency may wish to *designate* a financial asset as 'available-for-sale'. However, unless designated, the 'available-for-sale' category is a residual category of financial assets. Therefore, all financial assets not otherwise classified must be classified as 'available-for-sale'.
A potential example of an 'available-for-sale' financial asset is an investment in shares. However, some shares may also be classified or designated at 'fair value through profit or loss'. For example, this Policy requires investments in shares through the Hour-Glass Investment Facilities to be designated 'at fair value through profit or loss' unless 'held for trading' (refer section 5.4).

Available-for-sale financial assets are measured at fair value (AASB 139.46)[5], with gains or losses recognised in equity until derecognised (AASB 139.55(b) and Appendix A to the Policy), except for impairment losses, foreign exchange movements on monetary items, dividends, and interest (recognised using the effective interest rate method), which are recognised in profit or loss.

Key Policy Requirement

In limited circumstances where an agency wishes to *designate* financial assets as 'available-for-sale', written approval must be obtained from NSW Treasury. This will require the agency to explain the reasons for the designation each year.

All other financial assets not otherwise classified must be classified as 'available-for-sale'. No approval from NSW Treasury is required for this classification.

[5] However, investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, must be measured at cost (AASB 139.46(c) and Appendix A paragraphs AG80-AG81).

7. Non-trading financial liabilities

After initial recognition, an agency must measure all financial liabilities at amortised cost using the effective interest method, except (AASB 139.47):

- financial liabilities at fair value through profit or loss (refer section 5)
- financial liabilities designated as hedged items (refer section 8)
- financial guarantee contracts (as defined in AASB 139.9) (refer section 10)
- commitments to provide a loan at a below-market interest rate (refer Appendix A)
- financial liabilities that arise when a transfer of a financial asset does not qualify for de-recognition or when the continuing involvement approach applies (refer Appendix A).

This Policy refers to financial liabilities measured at amortised cost using the effective interest method as 'non-trading' financial liabilities.

However, Application Guidance to AASB 139 clarifies that short-term payables (and receivables) with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial (AASB 139.AG79).

8. Derivatives and hedge accounting

AASB 139 requires that derivatives must initially be recognised on the balance sheet at fair value (also refer to section 10 for derivatives that are financial guarantee contracts). A derivative is a financial instrument with the following three characteristics (AASB 139.9):

- its value changes in response to a change in price of, or index on, a specific underlying financial or non-financial item or other variable
- it requires no or comparatively little initial net investment
- it is to be settled at a future date.

Derivative financial instruments must be classified as 'held for trading' (AASB 139.9) and measured at fair value through profit or loss, except for:

- designated and effective hedging instruments, which are subject to hedge accounting (refer below) and
- financial guarantee contracts, where they satisfy the relevant definition (AASB 139.9), which are subject to separate measurement requirements, as discussed below (refer section 10).

Agencies do not require NSW Treasury's approval for the accounting treatment for derivatives. It is an agency's responsibility to determine whether to use hedge accounting or whether to account for derivatives as 'held for trading' and to determine whether the definition of a 'financial guarantee contract' is satisfied.

To qualify for hedge accounting, strict criteria must be satisfied including designation, documentation and effectiveness requirements (AASB 139.88-102). The different types of hedges and their accounting treatment are briefly summarised in Appendix A to the Policy. Agencies may utilise hedge accounting where the AASB 139 criterion is satisfied.

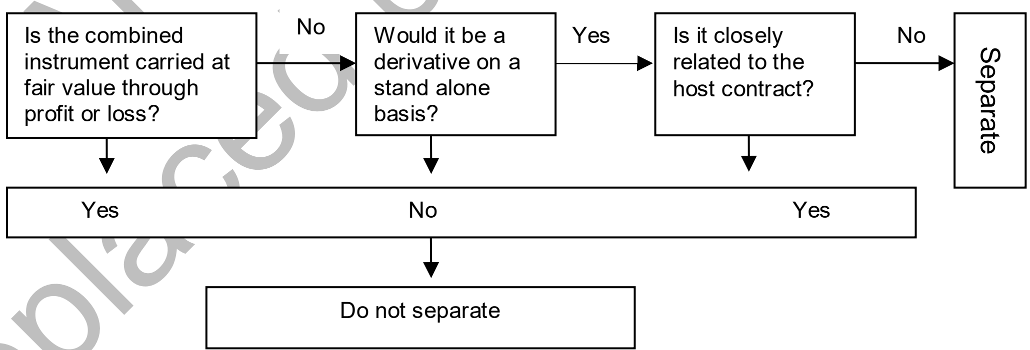
An embedded derivative is part of a combined instrument that includes both a derivative and a non-derivative host contract (AASB 139.10). It causes the cash flows of the host contract to be modified based on a variable such as an interest rate or commodity price (e.g. electricity supply contract linked to aluminium prices). An embedded derivative is required to be separated and recorded at fair value, with gains and losses taken through the profit and loss, if and only if (AASB 139.11) (also refer Diagram 1 below):

- the economic substance and risks of the embedded derivative are not closely related to the economic substance and risks of the host contract (for examples, refer to AASB 139.AG30 and AG33)
- it would otherwise meet the definition of a derivative on a stand alone basis and
- the combined instrument is not measured at fair value with changes in fair value recognised in profit or loss.

If a contract contains an embedded derivative the entity *may* designate the entire combined contract at 'fair value through profit or loss' in certain circumstances (AASB 139.11A). Further, if the entity is required to separate an embedded derivative but is unable to measure the embedded derivative separately, it *must* designate the entire combined contract as at 'fair value through profit or loss' (AASB 139.12) (refer section 5).

Examples and further discussion regarding embedded derivatives are included in the Application Guidance to AASB 139.AG27-33 and in Interpretation 9 *Reassessment of Embedded Derivatives.* It is important that agencies review the terms of all financial instruments and contracts to ensure that all material embedded derivatives have been appropriately identified and accounted for separately.

Diagram 1: When to Separate and Value an Embedded Derivative



9. Interest free and low interest loans

Under AASB 139, interest free and low interest loans must initially be recognised at fair value (consistent with other financial instruments) and amortised cost thereafter. The fair value of a long term loan or receivable that carries no interest or below market interest can be estimated as the present value of all future cash receipts, discounted using the prevailing market rate of interest for a similar instrument (similar as to currency, term, type of interest rate, and other factors) with a similar credit rating. In the public sector context, the market rate of interest is represented by the NSW TCorp Government bond rate, for the relevant term of the loan.

Any additional amount lent is an expense or revenue (generally classified as grant revenue or expense) unless it qualifies for recognition as some other type of asset / liability (e.g. investment in subsidiary or associate). Amortisation of the loan is recognised as investment revenue (or finance cost) using the effective interest rate method (AASB 139, Application Guidance, paras AG64-65).

Agencies will need to review the terms and conditions of each loan to determine the appropriate accounting treatment. For example, a loan that is repayable on demand is recognised at face value (i.e. with no discounting), as the face value approximates fair value. Alternatively, where there is no obligation to repay the loan, it is likely instead to be, in-substance, a grant that should be recognised as revenue / expense.

Where an interest free or low interest loan is provided or made between two NSW public sector agencies (e.g. between the Crown Entity and an agency), the appropriate accounting treatment must be determined and agreed in conjunction with the counterparty (also refer section 2.4). This is particularly important if the timing of the future cash flows is uncertain and where the fair value must be determined based on the best estimate of future cash flows.

An example outlining the treatment of an interest free loan is included in Appendix C to this Policy.

10. Financial guarantee contracts

10.1 Definition

Under AASB 139, a 'financial guarantee' contract is defined as:

> "….a *contract* that requires the *issuer* to make specified payments to reimburse the *holder* for a loss it incurs because a *specified debtor fails to make payment* when due in accordance with the original or modified terms of a debt instrument" (AASB 139, para 9) (italics added).

Financial guarantee contracts may take various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form (AASB 139, para AG4A).

'Financial guarantee contracts' may include:

- an entity guaranteeing the borrowings of a subsidiary / associate / joint venture; or customers
- other financial guarantees relating to trade debts, overdrafts and other borrowings like loans and certain debt securities.

However, 'financial guarantee contracts' exclude:

- performance guarantees, as the guarantor is not guaranteeing the payment of a debt
- letters of support between entities under common control, as the parent is usually not required to compensate any third party when the controlled entity defaults and
- statutory guarantees, as they are granted under statute rather than contract (AASB 132, para AG12). But, where a statute only provides the *power* to grant a guarantee (rather than granting the guarantee itself), any guarantee that is granted is regarded by NSW Treasury as a discretionary guarantee (rather than a statutory guarantee) that is potentially subject to AASB 139.

In NSW, for agencies other than the Crown Entity, financial guarantee contracts are most likely to arise where a financial guarantee relates to debts of parties outside of the NSW public sector. Agencies should review all contracts for any guarantees (where they are the *issuer*) that may meet the definition of a 'financial guarantee' contract.

10.2 Recognition and measurement

Under AASB 139, 'financial guarantee contracts' must initially be recognised by the issuer at fair value plus, in the case of financial guarantees not at 'fair value through profit or loss', directly attributable transaction costs (AASB 139, para 43). After initial recognition, unless at 'fair value through profit or loss', the *issuer* of a financial guarantee contract must measure it at the higher of (AASB 139, para 47(c)):

- the amount determined in accordance with AASB 137 (but under AASB 137, financial guarantees are likely only to be disclosed as contingent liabilities and therefore not recognised unless the specified debtor has defaulted or is likely to default) and
- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 (i.e. if a financial guarantee contract was issued in connection with the sale of goods (AASB 139, para AG4(c)).

[Therefore, unless a specified debtor has defaulted or is likely to default, financial guarantee contracts will be subsequently measured at fair value (as initially recognised) less, when appropriate, accumulated amortisation.]

If the financial guarantee contract was issued to an unrelated party in a stand alone arm's length transaction, its fair value at inception is likely to equal the premium received (i.e. amount charged as consideration for granting the guarantee), unless there is evidence to the contrary (AASB 139, para AG4(a)).

As the Accounting Standards do not prescribe how to determine the fair value, where the guarantee is provided at nil or nominal consideration, the following matters should be considered when determining the fair value of a guarantee:

- probability of default by the guaranteed party
- likely loss resulting from default
- the level of gearing (i.e. whether there will be sufficient assets to meet the obligations of creditors at that time) and whether the guaranteed party is solvent and liquid
- the likelihood that the guaranteed party would be inadequately funded to meet its financial obligations
- the stability of the industry / sector the guaranteed party operates in
- the overall capital management framework within which the guaranteed party operates.

Common methodologies that may be applied in practice include:

- interest rate differential analysis (i.e. by comparing the interest rate at which the debt is provided, compared to the interest rate that would have applied had there been no financial guarantee)
- expected liability based on loss events and probability of default (as illustrated in the example in AASB 137, para 39).

Where the guarantee is issued for nil consideration, the guarantee should initially be recognised at fair value as an expense and a liability (with the liability subsequently amortised over the term of the agreement, per AASB 139, para 47(c)).

For the Crown Entity, financial guarantees may also relate to the debts of NSW public sector agencies. However, most of these guarantees are statutory guarantees under s 22A of the *Public Authorities (Financial Arrangements) Act 1987* (whereby the Act *grants* the guarantee), which are excluded from the scope of AASB 139 (AASB 132, para AG 12). Any remaining non-statutory financial guarantees of NSW public sector agency debts are likely to be immaterial (after examining the above factors). This is due to the arrangements of government, which in NSW includes the Commercial Policy and Financial Management frameworks. These Frameworks put in place effective performance management, monitoring, capital structure and / or funding arrangements that minimise the risk of default.

11. Impairment of financial assets

AASB 139 requires that all financial assets, except those measured at fair value through profit and loss, must be subject to an annual review for impairment (AASB 139.58-70). Impairment losses are incurred only if there is objective evidence of impairment arising from events that impact on the estimated future cash flows of the financial asset or group of financial assets. This may result from the combined effect of several events. The Standard provides a number of examples of objective evidence of impairment, including (AASB 139.59):

- national or local economic conditions that correlate with defaults on the asset/s
- adverse changes in the payment status of borrowers and
- where there has been a breach of contract.

The amount of any impairment loss is calculated as the difference between the carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (for financial assets carried at amortised cost) (AASB 139.63). Where there is an impairment loss, the carrying amount of the asset must be reduced either directly or through the use of an allowance account. The impairment loss is recognised in profit or loss.

For available-for-sale financial assets, any fair value gains or losses must be recognised directly in equity. However, impairment losses must be recognised in profit or loss (AASB 139.67-70). For available-for-sale financial assets, a temporary movement in fair value is recognised in equity, but for a more prolonged decline (e.g. 10% or more decline in value for more than 12 months) that is supported by objective evidence (per AASB 139.59), the cumulative decline in fair value is recognised as an impairment loss in profit or loss, and removed from equity.

Any reversals in impairment losses are generally reversed through profit or loss, where there is objective evidence. However, there are some exceptions for equity instruments:

- Impairment losses on unquoted equity instruments not carried at fair value (i.e. because they cannot be reliably measured) cannot be reversed (AASB 139.66).
- Reversals of impairment losses for an investment in an equity instrument classified as available-for-sale (i.e. and recognised at fair value), must be made through the reserve (AASB 139.69).

Reversals of impairment losses of financial assets carried at amortised cost cannot result in a carrying amount that exceeds what the carrying amount would have been had there not been an impairment loss (AASB 139.65).

12. Treasury Mandates[6]

OPTIONS	TREASURY MANDATE
AASB 139 *Financial Instruments: Recognition and Measurement*	
Designation as 'fair value through profit or loss' or 'available-for-sale' at initial recognition; and use of the 'held-to-maturity' category (para 9).	No mandate, except for designation of TCorp Hour-Glass Investment Facilities at fair value through profit or loss (refer section 5.4). Apart from Hour-Glass Investment Facilities, an agency may only designate at 'fair value through profit or loss' where it (refer section 5): • satisfies the fair value option criteria • determines it is appropriate for its operations (e.g. NSW TCorp) and • is approved by NSW Treasury. An agency may only designate as 'available-for-sale' where it is approved by NSW Treasury (refer section 6). Further, an agency can only use the 'held-to-maturity' classification if approved by NSW Treasury (section 4).
Regular way contracts – AASB 139 provides the option of using either trade date or settlement date accounting for purchases or sales of financial assets under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned (para 38 and paras AG53-56).	Mandate trade date accounting; i.e. date on which the entity commits itself to purchase or sell the asset (refer AASB 139.AG55).
Basis for establishing fair value in an active market – Current bid / asking price or mid market price (para AG72)	No mandate – AASB 139.AG72 suggests that the appropriate quoted market price is usually the current bid / asking price, although the mid market price may be appropriate in some circumstances. The TCorp Medium and Long Term Hour-Glass growth facilities use the bid price (from 1 July 2005).
Hedges of firm commitments – a hedge of foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or cash flow hedge (para 87).	No mandate – this should not be a material issue for most NSW public sector agencies.
Hedging – where a hedge of a forecast transaction results in recognition of a non-financial asset or liability; or a forecast transaction becomes a firm commitment for which fair value hedge accounting is applied, the entity must either reclassify gains and losses recognised in equity to match the depreciation expense; OR include in initial cost of asset or liability (para 98).	Mandate inclusion in the initial cost of asset or liability. This reduces the record-keeping burden involved in transferring amounts progressively from equity to profit/loss.

[6] Early adoption decisions, where relevant, are made annually as part of a Treasury Circular on mandate options: refer Treasury website.

13. Classification or designation approvals

Classifications or designations requiring NSW Treasury approval (refer sections 4-6) should be submitted to the Principal Advisor, Accounting Policy.

14. Other references

Refer NSW Treasury's website, including relevant *Treasury Analysis*: www.treasury.nsw.gov.au Quick Links / Info for Agencies / Accounting Policy / Treasury Analysis – Changes in Australian Accounting Standards / Post 2005-06 Australian Accounting Standards / AASB 7 and AASB 2005-10

Appendix A - Summary of AASB 139 categories

AASB 139 *Financial Instruments: Recognition and Measurement*

Category	Definition/Criterion	Measurement
Financial assets or liabilities at fair value through profit or loss	A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions: (a) It is classified as held for trading (i.e. a derivative, acquired or incurred principally for the purposes of selling or repurchasing in the near term; or part of a portfolio managed together with recent evidence of actual short term profit taking) (AASB 139.9(a)); or (b) Upon initial recognition it is designated as at fair value through profit or loss. This designation may only be used where: • designation results in more relevant information, because either (AASB 139.9(b)) – it eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases or – a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management / investment strategy and information about the group is provided internally on that basis to the entity's key management personnel. • the contract contains one or more embedded derivatives – an entity may designate the entire combined contract as a financial asset or financial liability at fair value through profit or loss, except (AASB 139.11A): – where the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or – it is clear with little or no analysis that separation of the embedded derivative is prohibited. AASB 139 prohibits an entity from reclassifying a financial instrument into or out of the fair value through profit or loss category subsequent to initial recognition (AASB 139.50).	Fair value (AASB 139.46). Changes in fair value recognised through profit or loss (AASB 139.55(a)). Hedge accounting provides an alternative accounting treatment for derivatives that are designated and effective hedging instruments (where strict conditions are met) (AASB 139.85-102). Derivatives that are financial guarantee contracts are not classified as 'held for trading' and are subject to different requirements (AASB 139.47(c)) (refer below).

Category	Definition/Criterion	Measurement
Held-to-maturity investments	Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than those (AASB 139.9): • upon initial recognition designated as at fair value through profit or loss • designated as available-for-sale and • meeting the definition of loans and receivables. Held-to-maturity investments are subject to anti-tainting provisions (AASB 139.9, AASB 139.52). That is, an entity must not classify any financial assets as held-to-maturity if the entity has, during the current period or during the two preceding periods, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity, except in limited circumstances (e.g. as a result of an isolated event that is beyond the entity's control).	Amortised cost using the effective interest method (AASB 139.46). Changes are accounted for in the profit or loss when impaired, derecognised or through amortisation process (AASB 139.56).
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than (AASB 139.9): • those the entity intends to sell immediately or in the near term, which must be classified as held for trading, and those the entity upon initial recognition designates as at fair value through profit or loss • those that the entity upon initial recognition designates as available-for-sale or • those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available-for-sale. Loans and receivables could include loan assets, trade receivables, investments in debt instruments and deposits held in banks (AASB 139.AG26). Financial assets that do not meet the definition of loans and receivables (e.g. because they are quoted in an active market) may be classified as held-to-maturity investments if they meet the conditions for that classification (i.e. positive intention and ability to hold to maturity) (AASB 139.AG26).	Amortised cost using the effective interest method (AASB 139.46). Changes are accounted for in the profit or loss when impaired, derecognised or through amortisation process (AASB 139.56).

Category	Definition/Criterion	Measurement
Available-for-sale financial assets	Those non-derivative financial assets that are designated as available-for-sale or that are not classified as (AASB 139.9): • loans and receivables • held-to-maturity investments or • financial assets at fair value through profit or loss.	Fair value (AASB 139.46). Changes in fair value recognised in equity except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised, at which time the cumulative gain / loss previously recognised in equity is recognised in profit or loss. However, interest calculated using the effective interest method is recognised in profit or loss. Dividends are recognised in profit or loss when the right to receive payment is established. (AASB 139.55(b))
Non-trading financial liabilities	These are financial liabilities that are not: • financial liabilities at 'fair value through profit or loss' (see above) • derivatives that are designated and effective hedging instruments (see below) • financial guarantee contracts (as defined in AASB 139.9) (see below) • commitments to provide a loan at a below-market interest rate (see below) and • financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies (see below).	Amortised cost using the effective interest method (AASB 139.47). Changes are accounted for in profit or loss when derecognised or through the amortisation process (AASB 139.56).
Derivatives that are designated and effective hedging instruments i.e. only when strict criteria are satisfied (AASB 139.88-102).	*Fair value hedge* - A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss (AASB 139.86(a)).	Gain or loss is recognised through the operating statement for both the hedged item and hedging instrument (AASB 139.89).
	Cash flow hedge - A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss (AASB 139.86(b)).	Gain or loss on the effective portion of the hedging instrument is recognised directly in equity and any ineffective portion through profit or loss (AASB 139.95).

Category	Definition/Criterion	Measurement
	Hedge of a net investment in a foreign operation - Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (AASB 139.86(c)).	Accounted for similarly to cash flow hedges (AASB 139.102).
Financial guarantee contracts	A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument (AASB 139.9).	After initial recognition, an issuer of such a contract must measure it at the higher of: • the amount determined in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and • the amount initially recognised (i.e. fair value) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 *Revenue*.
Other financial liabilities	Commitments to provide a loan at a below-market interest rate (AASB 139.4).	After initial recognition, an issuer must measure such commitments, as above, for financial guarantee contracts (AASB 139.47(d)).
	Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies (AASB 139.47(b)).	Measured in accordance with AASB 139.29 and AASB 139.31.

Appendix B – Example calculations of amortised cost using the effective interest method: Financial Assets

Under AASB 139, amortised cost is calculated using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition (AASB 139.9). The calculation includes all fees that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method.

Agency A purchases a debt instrument with five years remaining to maturity for its fair value of $1000 (including transaction costs). The instrument has a principal of $1,250 and has a fixed rate of interest of 4.7% paid annually (i.e. $1,250 x 4.7% = $59 per year).

In order to allocate interest receipts and the initial discount (i.e. $250) over the term of the debt instrument at a constant rate on the carrying amount, interest must be accrued at the rate of 10% pa. The table below provides information about the amortised cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a) Amortised cost at the beginning of the year	(b = a x 10%) Interest revenue	(c) Cash flows	(d = a + b – c) Amortised cost at the end of the year
0	1000	100	59	1041
1	1041	104	59	1086
2	1086	109	59	1136
3	1136	113	59	1190
4	1190	119	1250 + 59	-

[Source: Adapted from Example B.26 IASB Implementation Guidance to IAS 39].

Appendix C - Example accounting treatment for an interest free loan

Agency A has provided an interest free loan of $10,000 to a community organisation with a single repayment to be made after ten years. The ten year TCorp Government bond rate at the date of origination was 6%.

Under AASB 139, interest free loans must initially be recognised at fair value. The fair value of a long term loan receivable that carries no interest can be estimated as the present value of all future cash receipts, discounted using the prevailing rate of interest for a similar instrument with a similar credit rating. For a public sector agency, this is the TCorp Government bond rate. Any additional amount lent (i.e. difference between amount lent and the present value) is a grant expense. Amortisation of the loan is recognised as interest revenue using the effective interest method.

Based on the above facts, the calculation of the present value of the repayment is as follows:

	Amortised cost at the beginning of the year	Interest	Cash flows	Amortised cost at the end of year
0	5584	335		5919
1	5919	355		6274
2	6274	377		6651
3	6651	399		7050
4	7050	423		7473
5	7473	448		7921
6	7921	475		8396
7	8396	504		8900
8	8900	534		9434
9	9434	566	10,000	0

Journal entries for first year (Year 0)

Dr Loan receivable	5,584	
Dr Grant expense	4,416	
Cr Cash		10,000
Recognise loan receivable at fair value		

Dr Loan receivable	335	
Cr Interest revenue		335
Recognise amortisation of loan		

Journal entries for first year (Year 1)

Dr Loan receivable	355	
Cr Interest revenue		335
Recognise amortisation of loan		

Etc through remaining years

Journal entry final year – repayment of loan

Dr Cash	10,000	
Cr Loan receivable		10,000
Recognise receipt of loan repayment		

Appendix D – Main differences TPP 08-1 compared to TPP 07-2

The main changes regarding disclosures, compared to the previous TPP 07-2, are in section 2.3 of this Policy. They incorporate additional / amended disclosure requirements arising from the adoption of AASB 7 *Financial Instruments: Disclosures.*

AASB 7 supersedes the disclosure requirements of *AASB 132 Financial Instruments: Disclosure and Presentation* and *AASB 130 Disclosures in the Financial Statements of Banks and Similar Financial Institutions.*

The main differences arising on the adoption of AASB 7, compared to the previous Australian requirements, are summarised below:

- Locates all disclosure requirements for financial instruments within one standard, replacing the disclosure requirements in AASB 132 (paras 51-95) and superseding AASB 130.
- Requires more extensive balance sheet and operating statement disclosures, and prescribes both qualitative and quantitative disclosures about agencies' exposures to risks; i.e. credit risk, liquidity risk and market risk:
  - qualitative information on (AASB 7.33):
    - exposures to risk and how they arise
    - objectives, policies and processes for managing risk and methods used to measure risk and
    - changes in the above from the previous period.

    AASB 132.56-57 only required agencies to disclose their financial risk management objectives and policies.
  - quantitative data based on information provided to key management personnel of the agency about (AASB 7.34):
    - the exposure to each type of risk arising from financial instruments and
    - concentrations of risk.

    If the data is not representative of the agency's exposure to risk during the period, the agency must provide further information that is representative (AASB 7.35)

    No similar requirement in AASB 132.
  - credit risk disclosures, including:
    - Information about the agency's maximum exposure to credit risk (AASB 7.36):
      - a description of collateral held as security and other credit enhancements
      - credit quality of financial assets that are neither past due nor impaired and
      - the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

      No similar requirement in AASB 132.
    - Analysis of financial assets that are past due or impaired, including a description of collateral held as security and the related fair value (AASB 7.37)

    No similar requirement in AASB 132.

  - Collateral and other credit enhancements obtained (AASB 7.38)

    No similar requirement in AASB 132.

- liquidity risk disclosures, including:
  - maturity analysis for financial liabilities showing the remaining contractual maturities and a description of how the agency manages the inherent liquidity risk (AASB 7.39)

    AASB 132.67 required only a maturity analysis for interest rate risk and did not require a description of how the agency manages the liquidity risk.

- market risk disclosure:
  - A market risk sensitivity analysis, including the effect of a reasonably possible change in the risk variables, together with the methods and assumptions used to prepare the analysis (AASB 7.40)

    AASB 132.75 discussed the possibility of a sensitivity analysis for interest rate risk. AASB 7 requires sensitivity analysis disclosure for each type of market risk; i.e. interest rate risk, other price risk and foreign currency risk.

- Other additional disclosure requirements:
  - Carrying amounts for all categories of financial instruments (AASB 7.8).

    AASB 132.94(e) only required carrying amount disclosure for some categories of financial instruments while AASB 7 requires disclosure for all categories.

  - A reconciliation of changes in the allowance for credit losses for each class of financial asset (AASB 7.16).

    No similar requirement in AASB 132.

  - Net gains or losses for **all** categories of financial instruments (AASB 7.20(a)(iii)-(v)).

    AASB 132.94(f) only required this disclosure for financial instruments designated as at fair value through profit or loss.

  - Fee income and expense arising from financial instruments not at fair value through profit or loss and trust or other fiduciary activities (AASB 7.20(c)).

    No similar requirement in AASB 132.

  - Hedge accounting:
    - For gains or losses on a hedging instrument in a cash flow hedge, agencies must show the amount that was removed from equity in each relevant line item in the income statement (AASB 7.23(d)).

      No similar requirement in AASB 132.

    - An agency must disclose separately gains or losses in fair value hedges on the hedging instrument and on the hedged item attributable to the hedged risk; the ineffectiveness recognised in profit or loss that arises from cash flow hedges and from hedges of net investments in foreign operations (AASB 7.24).

      No similar requirement in AASB 132.

- AASB 7 does not retain the relief from making parent disclosures previously available under AASB 132 and AASB 130.